Savings & Investments

Module Description

A sixty- to ninety-minute interactive program suitable for all audiences, designed to develop knowledge and skills that will enable participants to save and invest effectively to achieve their financial goals.

Materials

Rate of Return = 12%

The Effects of Compound Interest and Time

The Financial Planning Pyramid

The Rule of 72

Has Inflation Affected You?

Thinking About Investing?

Creative Saving Strategies

Individual Retirement Account Options

Note

Due to the complexity of the subject matter and a requirement for the presenter to possess sufficient background knowledge to field questions, this module provides for more detail than can normally be presented in a sixty- to ninety-minute program. The instructor should obtain as much information as possible about the level of financial knowledge and experience of the anticipated audience. **Instructors should select an appropriate program content that will fit the allotted time period and participant level of knowledge.** The instructor should have a listing of current rates of return and yields on all asset classes mentioned.

Notes

Relevant Websites:
www.lifelines4qol.com

Instructor References

SECNAVINST 1754.1, Family Service Center Program

OPNAV Instruction 1740.5A (Draft), Personal Financial Management Education, Training and Counseling Program

Command Financial Specialist Training Manual, NAVPERS 1560.8C (or later)

The ABC's of Managing Your Money, by Jonathan D. Pond, CPA

Everybody's Money Book, by Jordan E. Goodman

Making the Most of Your Money, by Jane Bryant Quinn

The Millionaire Next Door, by Thomas J. Stanley, Ph.D., and William D. Danko, Ph.D.

Personal Finance by E. Thomas Garman and Raymond E. Forgue

The Truth About Money, by Ric Edelman

The Wealthy Barber, by David Chilton

Objectives

At the conclusion of this program participants will be able to:

- Demonstrate how compound interest and time work to the benefit of the small investor.
- Describe the difference between saving and investing and what tools are used to accomplish each one.
- Explain three techniques of saving and investing.
- Know what an IRA is, how to start one and how it may enhance your financial future.
- Be familiar with financial resources and their availability for self study.

Introduction

1 **1. Introduce self**: Financial education background, affiliation with Navy.

2 **2. Introductory Questions and Discussion**: Ask some motivational questions and solicit answers from participants: How much money is enough money? How many of you would like to become rich? What does 'rich' mean? Which of these statements are true?

3

- **"You Have to Have Money to Make Money."** *Generally true*, but you don't have to have a lot. A small monthly amount can be the start of something big.

- **"The Rich Get Richer."** *True.* Often the rich are not any smarter than we are, but they do understand how money works; they understand how to make their money work hard for them. Your money should work just as hard for you!

- **"The Little Guy Can't Win."** *False!* In fact, today's marketplace actually offers a number of specific advantages to the "little guy". In today's workshop we'll explore how the ordinary, small saver/investor can achieve financial freedom.

- **Invest for the Long-Term**: They keys to successful investing are pretty simple: start early in life, be consistent and disciplined, capitalize on the effects of compound interest and time.

- **Start as early as possible:** The sooner you begin to put money aside, the longer your money will be working for you. This is so important that it is almost impossible to overemphasize. Some experts (such as Dorcas Hardy, former Director of the Social Security Administration) have said the average middle age person today will need at least a half million dollars to be able to retire comfortably (*not lavishly, comfortably*!). To get that half million at age 65, you need to save approximately $79 per month if you begin at age 25. But if you wait until age 35, you need approximately $221 per month; at age 45, approximately $658 per month. (assumes a 10% long-term rate of return, with taxes deferred.) 4

- **Effects of Compound Interest:** Compound interest, simply defined, is when the money you have already invested, earns even more money. It is like a snowball rolling down a hill in that you put money into your investment and it earns money during the year, so at the start of the next year you've got even more money to grow on. Albert Einstein is quoted as saying about compound interest, "It is the second greatest force in the universe, and mankind's greatest invention". Let's look at the handout "Rate of Return = 12%" to see how money can grow. 5
Refer to the "Rate of Return = 12%" handout, and review how money can grow. Tell them that there are places where an investor can possibly get 12%. This is a very ambitious but potentially achievable rate of return. 6

- **Rates of Return Over Time.** Another example of the effects of compound interest is seen in the difference that various rates of return have on a monthly deposit of $50 over a period of thirty years. Refer to Effects of Compound Interest and Time. Emphasize difference in rates of return. This is a sum most of us can budget. It's not pocket change, but most military families can manage to 7 save $100 per month. If that amount is saved (no interest), just tucked away, it will equal $36,000 over thirty years. The same amount accumulating at 5% will grow to about $83,673, and with a 10% rate of return to over $228,033. The greater the rate of return and the longer your money works for you, the more you will eventually earn.

8

Compound interest is a powerful force. Unfortunately, when some people see their money begin to add up they feel a temptation to spend. What if after five years of saving you decided to use the approximately $7,800 that had grown (at 10%) to buy a car? If you continued to save the same amount at the same rate your money would only grow to $133,889 instead of the $228,033 if you had left ALL the money in the account. In other words, you could say that the car didn't cost you $7,800, but $94,144 when you account for the lost growth. The message? Save regularly and leave it alone to grow.

9

3. **Purpose:** The purpose of this program is to help you chart a course from your present financial situation to financial independence by understanding and knowing how to use the tools and techniques of saving and investing.

The Tools of Saving and Investing

10

1. The Financial Planning Pyramid

Just as the pyramid derives its strength from a wide, solid base, so should your financial plan. The base level needs to be established before moving up to the saving and investment levels. The foundation of any good financial plan should be made up of adequate compensation and some method for controlling spending, including a written spending plan or budget and the wise use of credit. In addition, most everyone needs some insurance protection (life, property, disability and/or liability). Insurance is not designed to make you rich - it is to help keep you from becoming poor. Once the needs at the base of the pyramid are met, an effective and systematic savings plan should be implemented. Not until savings are established, especially emergency savings, should you venture into the investment levels.

NOTE:
Refer class to the Financial Planning Pyramid

2. Savings

11

As you can see from the Financial Planning (PPT 11) Pyramid, once you have satisfied the management level of the pyramid you are ready to proceed with your savings plan. A sound savings plan consists of three components:

- **Emergency Fund.** This is a cash reserve set up in a safe, easy-to-access savings account to provide a cushion against unexpected financial emergencies like emergency leave to visit a sick parent, transmission on the car, etc. The amount in the emergency fund is an individual decision, but a commonly used guideline is to have three months of expenses set aside. The amount may be larger or smaller depending on the size of your family, upcoming transitions or retirements, rental property, etc., but the guideline provides a good starting point.

Notes

- **Reserve Fund**. Money should be available in savings to cover those expenses which are predictable but which do not occur on a monthly basis, such as car insurance, regular car maintenance, taxes, birthdays, anniversaries, and holiday spending. We should know approximately what these annual costs would be, so it is easy to determine the monthly amount that should be put aside in advance. Divide the annual expense by 12, and put that amount aside monthly.

- **Goal-Getter Fund(s).** The purpose of this fund is to provide savings for short-term (need money in less than 5 years) goals such as buying a car, putting a down payment on a house, or financing a special vacation.

3. Factors used to evaluate your saving and investing tools: Safety, Liquidity and Yield

Before we discuss specific savings tools, you need to know the three main factors that we use to evaluate our saving and investing products. They are safety, liquidity and yield.

- **Safety.** Is the account insured? How safe is the principal.

- **Liquidity**. How quickly and easily can you get to your money in an emergency?

- **Yield** (or Rate of Return). How much does your money earn (what is the rate of return)? Is it a 'good' return?

When considering the **"SLY"** factors, remember that there are trade-offs. You can have at most two out of three of these factors in any one account or investment. For example: for your emergency fund, safety and liquidity will be most important, so you will have to sacrifice some yield to ensure the presence of the other two factors.

4. Savings Tools

12

Now that we know how to evaluate our saving and investing tools, let's look at some specifics in each area. There are generally four options for savings: savings accounts, certificates of deposit, money market accounts and U.S. Savings Bonds. Each should be evaluated in view of safety, liquidity, and yield.

Regular Savings Accounts or Share Savings Accounts

- **S**afety - Guaranteed up to $100,000 (per Social Security Number) if federally insured.
- **L**iquidity - No restrictions on withdrawals.
- **Y**ield - Generally carry lowest rates of interest. (Currently ______________)

Certificates of Deposit (CDs) or Time Deposits

- **S**afety - Guaranteed up to $100,000 if federally insured.
- **L**iquidity - Funds are invested for a fixed period, usually 6 months to 5 years. CD's may be liquidated at any time, but if it is prior to the maturity date some interest may be forfeited.
- **Y**ield - Higher than savings deposits; the longer the term, the higher the yield (Currently __________).

Minimum deposits (usually at least $500) required. Often called share certificates at credit unions.

Money Market Accounts (MMA)

- **S**afety - Safe, but may not be federally insured, depending on where the account is maintained. A money market Deposit account at a bank or credit union should be insured up to $100,000 per account. A money market account held at a brokerage or through a mutual fund will typically not be insured at all.

- **L**iquidity – Generally, there are no restrictions on withdrawals. May be a large minimum deposit required, may be a required minimum balance; may be a fee for withdrawals. Often include check writing privileges.

- **Y**ield - Generally low, but higher than regular savings. Varies with changes in interest rates. May be attractive if rates are rising rapidly. (Currently __________)

US Savings Bonds

- **S**afety - Guaranteed by the US Treasury.

- **L**iquidity - Can be redeemed after 6 months, but receive a lower interest rate if held for less than 5 years.

- **Y**ield - Rate equal to 85% of the average yield on 5 year US Treasury securities, or 4% whichever is greater. For current yield call 1-800-4USBOND. (Current rate ___________)

Additional information on savings bonds: Purchased at financial institutions or directly by payroll deduction (or allotment), for one-half face value ($100 bond for $50). Time to mature will vary with the interest rate. Interest is tax deferred-does not have to be paid until bond is redeemed (and may be tax-free if proceeds are used for certain higher education expenses). Interest is always exempt from any state or local income tax. Can be converted to US Savings Bonds, Series HH, to receive annual income payments. HH bonds are only available through conversion; they cannot be bought directly.

NOTE:
Refer class to the Rule of 72 Handout, explain how to calculate when money will double and triple.

Asset classes moved to later in program

5. Saving vs. Investing 13

Saving is the primary step towards financial security. You do not want to start an investment plan until you have a solid emergency fund for a safety net. However, for long range goals (such as children's college or retirement) it is important to get a better rate of return than is available in a savings account. For this we look to investing our money.

What is the difference between saving and investing? One of the big differences is the **time frame**. If we need our money in five years or less, it is best kept in a savings vehicle. But if we won't need the money within five years, it is best put into an investment vehicle where it can earn a higher rate of return.

Another big difference between saving and investing is (the 'safety' of the investment. This is referred to as "**risk**". There is risk involved in EVERY type of investment tool. These risks differ, depending on where you place your money. Among the most common types of risk are: 14

- **Physical Risk**: Theft, loss of principal.
- **Market Risk**: The ups and downs of the stock market. This is what most people think of when they consider the risks of investing. If an investment goes down in price, you have lost money at that point (assuming you have sold). However, market risk is often reduced when money is in a sound investment over longer periods of time.
- **Interest Rate Risk**: The price of some investments fluctuates with changes in interest rates.
- **Inflation Risk**: Probably the greatest risk to your money over the long term. In order to keep ahead of inflation in your long-term savings/investments, you will need to accept a greater degree of the other risk. An annual inflation rate of only 3.5% will cut the value of your money in half in 20 years.

Many people never invest their money because they are afraid of losing any of it—they don't want to take on any risk whatsoever—so they keep all their money in the bank. Unfortunately, doing that can mean they will never achieve their financial goals because they never take advantage of the bigger earnings available in the market. Some risk can be minimized through diversification, which will be addressed later. For now, keep in mind that the riskiest thing you can do with your money may be to do nothing at all. Risk is not something to be feared, but to be managed. Knowledge of investing will help you manage it.

15 A final difference between saving and investing comes in the form of—**inflation and taxes**. In investing we are more concerned with overcoming both of these threats to our returns. The purpose of investing is to get your money to increase in value even when the effect of taxes and inflation are taken into account.

16

- **Inflation:** Inflation is an increase in the cost of goods and services. Inflation means that what costs a dollar today will cost more than a dollar in the future. Ask**: Does anyone know what the current rate of inflation is?** Current inflation rate is __________. Historically inflation has averaged 3.37% over the last 70 years. Let's take a look at the handout "Has Inflation Affected You" so you can see what inflation means to you in your everyday life. The handout referenced above has 'fill in the blank' spaces for the prices of products in 1975. The answers are as follows: First class stamp: $0.10. Box of Corn Flakes: $0.39. Jar of Instant Coffee: $2.79. 60-watt Light Bulbs (2pack): $0.43. Ford Mustang (Hardtop): $3,261. Oil Change: $4.88. Bayer Aspirin (100 count): $0.69. Pork Chops (1lb): $0.29.

- **Taxes on Savings:** [Instructor Note: If time is limited, you may want to limit this discussion on taxes. Information is included for your information in case questions arise.] Earnings on your savings are taxed each year. If you earn interest or dividends on your savings and/or checking account you will receive a statement from the bank or credit union at tax time indicating how much you earned. You must include it as unearned income on your 1040, and you will be taxed on it at what is called your Marginal Income Tax Bracket (MITB), which is usually 15% or 28% for most of the Navy's taxpayers.

- **Taxes on Investments:** Earnings on your investments come in a couple of forms—dividends and capital gains.. At the end of each year you will get a statement noting the earnings on your investments, and you will need to include this income on your tax returns as well. Capital Gains are taxed like this: short-term (held investment 12 months or less) gains are taxed at your MITB; long-term (held investment more than 12 months) gains are taxed at

10% if your MITB is 15%, and are taxed at 20% if your MITB is 28% or higher. Isn't it great how the government uses a lower tax rate to encourage you to invest for the long term?

- **Example:** If you buy one share of stock for $50 and sell it for $60, your capital gain of $10 will be taxed based on how long you held the stock and what your income tax bracket is. You only pay taxes when your holdings for more than you paid for them. Mutual Funds, on the other hand, pass Capital Gains on to the investor every year, whether you sell your shares or not. We'll talk more about mutual funds in a little while. Recommend that participants seek the assistance of a tax professional if needed. Also, emphasize here the importance of good record-keeping.

17

6. Introduction to Asset Classes

As we move into a discussion of investments, you will note that there are only two ways to invest: equity and debt. When you invest in equity, you become an owner. When you invest in debt, you become a lender.

There are four types of asset classes. As an owner (equity) you can buy growing assets (normally stocks of publicly traded companies) or so-called hard assets (such as gold, real estate, or collectibles). As a lender (debt investments) you can loan money via bonds, or via cash (such as short term savings deposits). Each of these four asset classes can play a part in a diversified investment portfolio.

The two asset classes that people think of most commonly when they consider investing are stocks and bonds. We will discuss each of these two types of investments in more detail now.

7. Stocks (Equity): Common stocks are the classic equity investment; in fact, 'equities' is another name for stocks. Here are a few facts about stocks: 18 19

- Common stocks represent ownership in a company.
- Returns come from dividends and/or an increase in stock prices; dividends represent profits passed on to shareholders.
- Stocks normally are the best long-term way to beat inflation and represent the best opportunity for long-term growth of your money.
- Stocks have returned 10—12% annually for the past 70 years. What does this mean to you? First it should indicate that you can earn more with your money in the stock market than with your money in the bank. But what is the trade off? Safety and liquidity to some degree. We already said you should always be prepared to lose money, but you should also expect a decent rate of return if you have done your homework. Remember that with risk goes the potential for a greater return.
- Does anyone know what the stock market has returned in the past twelve months? ________. How does this compare with the average over the last 70 years of 10 – 12%? How does it compare to what your money earned in the last twelve months?
- Growth stocks are excellent for retirement accounts and/or long-term goals. The longer you have, the better it is to use equities, because the market has historically grown.

8. Bonds (Debt) Bonds are a way of loaning money. A company will sell a bond, but what they are really doing is asking you for a loan. If you give them the loan (buy the bond) they give you an IOU and a promise to repay the loan within a certain period of time, and in the meantime to pay you interest, usually twice a year. If you buy a bond, you are actually lending money 20

Notes

to someone (a company or a government), unlike when you buy a stock, where you are purchasing a portion (share) of the company. Here are a few facts about bonds:

- Bonds represent an IOU.
- Companies and governments, i.e., cities, states and federal governments, issue bonds.
- Bonds have a fixed interest payment, so they usually provide reliable income.
- Bonds can have a high degree of risk (a low 'rating')—you can research the 'rating' of a bond to ensure you only buy ones that match your risk tolerance.
- Bond returns have averaged 4 – 7% over the past 70 years
- Bonds are moderately liquid—chances are you won't get your money out of a bond the same day you need it.

21

9. Which is better—Stocks or Bonds?

Both can be good (or bad) investments. For young people starting to invest, over long periods of time it is usually better to be an owner rather than a lender. Stocks generally have a higher return over extended periods of time than bonds. If you are not just starting out, or have recently received a large sum of money, you may need to have both stocks and bonds to be properly diversified. Seek the assistance of a financial planning professional if you need it.

22

10. Mutual Funds

Mutual Funds provide an alternative to selecting individual stocks. Mutual funds are investment companies that pool money from many investors with similar goals. They invest in different stocks and/or bonds, giving their shareholders the value of diversification, as well as the benefits of having their money professionally managed.

Profits 23

Mutual funds make money for shareholders in several ways.

- The investments the fund owns may pay dividends (stocks) or interest (bonds).
- When the manager sells an investment for a profit, there will be a capital gain.
- There will be an increase in share price (Net Asset Value, or NAV) if the fund performs well.

Dividends and capital gains must be paid out regularly to the fund's shareholders. Many people choose to reinvest this money right back into their account. Whether they take the money or reinvest it, income tax must still be paid on the profits at the end of the year (unless the mutual fund is in an IRA – to be discussed later).

Advantages: 24

Mutual funds offer a number of advantages:

- **Diversification** – Mutual funds can offer automatic and immediate diversification. When you diversify, you put your money in a mixture of different individual securities; if one performs poorly, the others may make up for it. Diversification helps spread the risk around, and also the opportunity. This can be difficult to do for a new investor developing his or her own portfolio independently—it takes time, education, and larger investment amounts. Mutual Funds make diversification easy and cost-effective.

- **Liquidity** – Funds are relatively liquid and can be redeemed in two weeks or less.

Notes

- **Convenience** – Some offer check writing privileges but sometimes carry hefty fees for the service.

- **Professional management** – This is a major benefit. An individual who invests in a mutual fund is actually hiring a professional money manager to manage his or her money. It allows the small investor to benefit from the knowledge and experience of the pro's, something that used to be available to big investors only.

- **Flexibility**- Funds are a flexible way for a small investor to own securities. Although minimum amounts vary widely, some can be started for as little as $50.00. Many funds will help an investor to arrange automatic withdrawals from a checking account, or accept allotments.

25

Disadvantages:

There are also some disadvantages:

- **Not Insured** – Mutual funds are not federally insured as are your deposits in a bank or credit union.
- **Risk**—There are high-risk funds and low risk funds.
- **No Guarantee -** There is never a guarantee as to what you will earn.
- **Fluctuation** – You must be willing to take the 'ups' and 'downs' of the market.

Types: Here are some of the common types of mutual funds, arranged in general from the most volatile / risky at the top to the safest at the bottom: 26

- Funds invested in the **stock market**
- Funds invested in the **stock market and bond market**
- Funds invested in the **bond market**
- Funds invested in the **money market**

Choosing a mutual fund 27

There are over 10,000 mutual funds out there—how do you choose one? You can narrow the field when choosing a mutual fund by looking at the following:

- **Your goals and objectives:** The objective of the fund should match your objective. For example, if you just want your money to grow, go with a large 'growth' fund.

- **The fund's performance history:** Although past performance is not an indicator of future performance, sometimes it is all you have to go on. Look for a fund with good one, three, five and ten year returns. The returns should be at least as good as other funds in its category.

- **Management:** The manager's performance history and his or her length of time with the fund may help in the decision. The longer the manager has been with the fund, the more you can rely on getting the same returns the fund has gotten in the past.

- **Costs:** You don't get something for nothing, so there are costs to buying mutual funds. These costs may be expressed as "Loads", which is a sales commission you'll pay to the person who sold you the fund. Loads can be as high as 8.5%, and can be assessed when the fund is purchased ('front-load'), or redeemed ('contingent deferred sales charge' or 'back-load'). If you are going to buy a mutual fund with a load, be sure you are satisfied with the services of the person who is selling you the fund. You can also buy 'no-load' funds, where no commission is charged. Funds will also have annual expenses (you won't see them taken out of your account, but they affect fund performance.) All loads, expenses, and fees are disclosed in the fund prospectus.

- **Services:** Many mutual funds are part of a larger organization (called a 'family' of funds) which will offer many funds with different investment objectives. Investors may be permitted to transfer money to a different fund at little or no charge as their goals or investment outlook changes. Some funds allow withdrawals by check writing. Other services may also be available. Most funds have toll-free numbers to call for free information as well as websites.

28

11. How to Purchase Your Investments

There are a variety of ways to purchase your chosen investment tools. In the past a small investor would have to go to a stockbroker to get stocks or bonds, but competition, new laws, and the internet have created a financial supermarket conveniently accessible to anyone.

Stocks and Bonds can be bought through a full-service brokerage, a discount brokerage, through mutual funds, via direct reinvestment plan (DRIP) plans, through a financial planner, and over the internet. Full service brokers will charge a commission and/or a fee, but you will get access to their research and advice. Discount brokers will charge a much smaller fee for the transaction, but you will get little, if any, advice. Brokers and discount brokers can be found in the yellow pages under Stock and Bond Brokers. You can also buy stocks through a Dividend Reinvestment Plan, or a DRIP.

DRIPS provide an opportunity to buy stock direct from over 1000 companies. Investors can choose to have dividends reinvested in additional shares (or partial shares) to compound their earnings. There are some fees associated with buying stocks through DRIPS, but they are typically smaller than what you would pay at a full-service brokerage. You can get into these plans with as little as $50 for an initial purchase and monthly minimums can be as low as $10. In many cases the first share (to become an owner of record) can be purchased directly from the company. In other cases you will need to purchase one share from a broker and then enroll in the company's DRIP. This is a less expensive method to build your stock portfolio in many well-organized companies such as Ford Motors, McDonald's, Goodyear, PepsiCo, and Walgreen, but you are responsible for determining whether the companies belong in your portfolio. For more information check the home pages of these and other major companies, or simply search for information on the web.

Mutual funds can be purchased through a full-service broker, discount broker, financial planner, a bank or credit union investment advisor, or directly and easily from a fund family via the phone and the mail. A financial service professional can provide both a Prospectus and an Annual Report for a mutual fund. When dealing with a fund directly, the prospectus will be sent when you request information on the fund. It may also be helpful to consult additional sources of information on mutual funds prior to investing. A wide range of information is easily available, and most of the information you need can be found by consulting rating services such as Morningstar or Lipper. Purchasing a mutual fund can be as easy as calling your chosen mutual fund, asking for an application, filling it out and sending it back with your check. Having done that, you are now an investor.

Internet: For participants planning on using the internet for research or trading, refer them to the handout, Thinking of Investing? And review.

29 *The Techniques of Saving and Investing*

30 **1. Pay Yourself First**

- Start with the basics by establishing a realistic spending plan that includes paying down debt and building a positive cash flow. Make sure you have adequate income to pursue a savings and investment plan, and that you are adequately insured. Refer to "Creative Ways to Save" and encourage participants to find saving and investment dollars anywhere they can. Invite to a budgeting program, if appropriate.

- Save from the top of your spending plan versus the bottom (don't save whatever is left after all of your expenses are paid, make your savings and investments a regular expense, too.) Set up a savings allotment—you won't miss it if you don't see it.

31 **2. Maximize any Tax-Deferred Investment Opportunities**:

Put the maximum amount of money into any tax-deferred investment that you qualify for. The two most popular of these are the 401k and the Individual Retirement Account, or IRA.

- **401k**: The US Navy does not yet have a 401k, but if your spouse has one at his or her work, they should put the maximum amount allowed into it. A 401k is a type of retirement plan that employers provide as a benefit to their employees. Usually an employee can contribute a certain percentage of their gross income (can be as much as 15% or more) to this plan BEFORE TAXES. Often employers will match a certain portion of the employee's contribution. Most 401k plans provide several options for investing plan money, usually a variety of mutual funds. 401k's allow you to take advantage of pre-tax contributions as well as tax-deferred growth. Some non-profit employers (such as schools) have similar plans called a '403(b)'.

- **Individual Retirement Accounts (IRAs):** Anyone in the Navy can have an IRA. An IRA in itself is not a product, it is a status. Think of an IRA as a bucket that you put your assets into (may be cash, stocks, bonds, or mutual funds). Once the money is in the bucket, there are special rules that apply as far as who can put money in, who can take it out, when and how much can be put in or taken out, and how it will be taxed. We will address three types of IRA's here: the traditional IRA, the Roth IRA and the Education IRA. Refer class to the handout "Individual Retirement Account Options". Review Eligibility, Deductibility of Contributions, Annual Maximum Contribution, Taxation and penalties as needed.

- **General Rules:** There are a few rules that apply to both the Traditional and the Roth IRA. They are:

- **Eligibility**: An individual can have an IRA if he or she has earned income. If the individual is married, a non-working spouse may make a contribution as well.

Notes

- **Contribution**: Up to $2,000 annually or earned income, whichever is less. Non-working spouse may contribute up to the same amount in his or her IRA.

- **Withdrawal**: Generally money cannot be with- drawn without a penalty (10%) until you are 59 ½. Exceptions to this rule include money withdrawn to make a first-time home purchase or to pay college tuition for children (limitations apply).

- **Earnings**: Grow tax-deferred in all IRAs.

32

- **Traditional IRA:** For those who qualify, (PPT 32) contributions are tax deductible and growth is tax-deferred. If you are covered by an employer-provided pension plan (this includes military personnel) this deductibility is subject to a phaseout. See chart for phaseout amounts. **WITHDRAWALS ARE TAXED** as ordinary income. Withdrawals must begin the year after the year you turn 70½.

33

- **The Roth IRA:** The Roth IRA became available (PPT 33) in 1998. Contributions to a Roth are never deductible, however, with a Roth IRA not only will your contributions grow tax free, but there is **NO TAX UPON WITHDRAWAL** provided you meet the following conditions: 1) The Roth IRA must have been open for five years, and 2) you are age 59 ½. You may **convert** your traditional IRA to a Roth IRA, but you will have to pay taxes on the contributions that you have deducted in the past. There are some income limitations for a Roth IRA—see chart. Also, note that your annual IRA contribution may be allocated between your traditional and your Roth IRA as long as the total does not exceed $2000 per year.

- **The Education IRA:** These IRAs are designed to help you save money to pay for qualified higher education expenses for your minor beneficiaries. These beneficiaries must be under 18 years of age. A total of $500 per year may be contributed for each beneficiary. Contributions are not deductible. Distributions must be started by the time the beneficiary reaches 30 years of age. The funds in an educational IRA can be rolled over or transferred to another educational IRA for another family member. Distributions are tax free if they are used for "qualified education expenses", including post-secondary tuition, fees, books, supplies, and certain room and board costs. Otherwise, growth is ordinary income when distributed, and if distributed early they will bear a 10% penalty, with some exceptions. See handout for other details. 34

Funding IRA's: Note that virtually any type of savings or investment that can be put in a regular (taxable) account can also be used to fund an IRA. Since this is money for long-term goals, an individual should consider seeking an investment that will return a higher rate of growth. Stocks and stock mutual funds are ideal. If you are not sure where you should invest, start by opening an IRA account at your bank or credit union. Begin getting the tax benefits and growth, and then investigate other options; the account can always be transferred to a different investment with a better rate of return after the service member has done additional homework.

3. Dollar Cost Averaging 35

While we are talking about saving regularly, this would be a good place to discuss the technique of dollar cost averaging. Not only does a regular monthly savings plan ensure that you WILL save, but it also allows you to take advantage of market swings. To explain, some people prefer to hold onto their money and make their investments when the market appears more favorable to them. This is called market timing. There is no way of predicting when the market will go up or down, so these people who wait stand a good chance of missing out on some great opportunities. On the other hand, what happens if you invest a set amount at regular intervals – let's say monthly – no matter what the market is doing? First of all, it will get you started on your investment plan today. Second, you will find that for your long-term goals, you will come out ahead, even when the market is down. Let's say you invest $100.00 every month into a mutual fund. When the market (price) is up you will buy less, and when the price is down you will buy more. This practice levels the peaks and valleys, or highs and lows, of share prices and provides an average value for shares when you sell.

36

4. Learn more about Saving and Investing

Even if you plan to work with a broker, financial planner, or other investment advisor, it will still help if you improve your knowledge about what you plan to invest in; remember, no one is as interested in your family's financial future as you are. **Show copies of any magazines, newspapers, or books brought to the program. Emphasize that much of this information is free at the library, or at NFSC. A course on investing at a local community college or adult education can be interesting as well as informative. Free seminars, given by individuals and organizations in financial services as a way to attract potential clients, can also be useful.**

Sources of Information

- Personal Finance Magazines (Kiplinger's, Money, Smart Money, etc.)
- Investment Publications and Ratings Services (Standard & Poors, Moody's, Morningstar, Lipper's, etc.)
- Public Library
- Newspapers (Local Business Section, Wall Street Journal, Barron's, Investor's Business Daily)
- Financial/Business programs on TV & Radio
- Non-profit organizations
- ICI—The Investment Company Institute (Mutual Funds)
- American Association of Individual Investors
- Local Investment clubs
- Adult Education
- Universities and Community college
- Adult learning centers
- Seminars (professionally sponsored)
- Internet Sites
  - www.lifelines4qol.org
  - www.consumerworld.org
  - www.sec.gov
  - www.amex.com
  - www.nyse.com
  - www.nasdaq.com
  - www.investoreducation.org
  - www.ici.org
  - www.invest-faq.com

and many, many others …

Note: A vast amount of information is available on the Internet. Use caution; free investment information on the Internet may be worth exactly what you pay for it. Always know the source of the information.

Handout:
"Thinking of Investing".

37

Summary and Conclusion

The world of saving and investing can be large and intimidating if you don't know the basics and aren't familiar with the language. Ease your way into it by charting your own course—follow these steps to reach your final destination of financial independence:

Take Action

Even if you learn all about saving and investing, it won't get you anywhere unless you take action. Remember the time value of money; the sooner you get started, the better off you will be.

1. **Calculate your Net Worth**
2. **Determine your Financial Goals**
3. **Establish emergency, reserve and goal-getter savings funds**. Start small if necessary, but start. Remember, borrowing puts you on the wrong side of the compound interest equation. Your goal should include having 3 months of expenses in emergency savings, and putting aside about 10% of your income for long-term goals.
4. **Build an investment portfolio**. Open up an IRA as soon as you can. Choose a mutual fund or the stock of a company you have researched. Interview and hire a financial professional if you prefer to have assistance.

5. **Keep learning.** New information is available all the time, and the investment environment changes frequently. Read books and magazines, attend classes, talk to fellow investors, start an investment club.

6. **Keep At It!** Finally, once you get started—keep at it! Continue saving for both short- and long-term goals. It takes time to produce virtually anything worthwhile. Never take money out of your IRA or other long term investments for short-term objectives—that's why you have established a goal-getter or emergency fund. Becoming wealthy is a lifelong journey—stay the course and financial independence will be yours.